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January 31, 2000

Ms. Tammy Croote
Office of Management and Budget
Desk Officer for the Department of the Interior
725 17th Street, N.W.
Washington, D.C. 20503

Re: Notice of Further Supplementary Proposed Rulemaking on Establishing Oil Value for Royalty Due on Federal Leases (64 F.R. 73820) published December 30, 1999

Dear Ms. Croote:

This letter is written in response to the Department of Interior, Minerals Management Service's Notice of Further Supplementary Proposed Rulemaking dated December 30, 1999 on Establishing Oil Value for Royalty Due on Federal Leases (64 F.R. 73820).

Enclosed is an analysis of the MMS proposed rule. Additional comments from the undersigned associations and their member companies are being filed directly with the MMS.

Sincerely,

Patsy Bragg

Patricia Dunmire Bragg
on behalf of:

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA
INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES

CHEVRON U.S.A. INC.
CONOCO INC.
MARATHON OIL COMPANY
OXY USA INC.

ANALYSIS OF THE DEPARTMENT OF INTERIOR, MINERALS MANAGEMENT SERVICE'S THIRD FURTHER SUPPLEMENTARY PROPOSED RULE ESTABLISHING OIL VALUE FOR ROYALTY DUE ON FEDERAL LEASES

64 FED. REG. 73820
DECEMBER 30, 1999

Prepared by

BARENTS
GROUP • LLC

A KPMG Company
2001 M Street, NW
Washington, DC 20036
202-533-5362

January 31, 2000

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EXECUTIVE SUMMARY

Barents Group LLC was retained by Gardere & Wynne, L.L.P. on behalf of a group of companies having significant crude oil production on Federal lands, to assist in analyzing the Department of Interior, Minerals Management Service's (MMS) economic analysis of a proposed rule establishing a new method for valuing oil for royalties due on Federal leases (64 F.R. 73820, published December 30, 1999). These companies are interested in and affected by the MMS proposal. In making these comments, our intent is to assist in the development of an effective and workable rule.

Key Objectives in the Rulemaking Remain Unaccomplished

In this report, we analyze whether the MMS further supplementary proposed rule on oil royalty valuation:

a.) Accomplishes its intended primary objective as stated by MMS of capturing market value at the lease: "The rule provides for royalty payments based on no more than the value of production at the lease. Where index prices are used to establish value, actual transportation costs, location differentials, and quality adjustments would be applied in arriving at the value at the lease."[1]

> *We find the proposed rule does not accomplish its primary objective of capturing value at the lease*

b.) Accomplishes its secondary intended objectives in developing a crude oil valuation rulemaking [2]

> *We find the proposed rule does not accomplish MMS' previously outlined objectives of creating a rule that will (1) provide certainty to all involved; (2) simplify royalty valuation; (3) reduce the need for audit, (4) minimize royalty disputes; and (5) provide maximum flexibility to adapt to changing market conditions, and (6) assure that the taxpayers of this nation get a fair return for their oil and gas resources*

c.) Applies the most efficient and fair valuation method from among the menu of feasible alternatives.

> *We find that MMS has not adequately or thoroughly explored viable alternatives and that these alternatives may be more efficient and fair*

d.) Does so without imposing undue burdens and uncertainties on the private sector.

> *We find that MMS does not accomplish these objectives and that the proposed rule would be unnecessarily costly and burdensome.*

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[1] News Release, "MMS Proposes Further Amendments to Federal Crude Oil Valuation Rule," Minerals Management Service, February 5, 1998.

[2] Testimony of Sylvia Baca, Acting Assistant Secretary, Minerals Management Service, before the Subcommittee on Government Management, Information and Technology, House Committee on Government Reform, House of Representatives, May 19, 1999

Key Questions for the Office of Management and Budget Remain Unanswered

The above stated questions are the key kinds of questions that the Office of Management and Budget (OMB) generally asks when evaluating an agency's proposed rule. In addition to these questions, OMB also assesses an agency's compliance with several relevant laws and executive orders; namely,

1. *Executive Order 12866* – Is the proposed rule (a) economically significant, (b) inconsistent with other agencies, (c) dealing with entitlements/grants, or (d) creating any novel, legal, policy issues?

   OMB has concluded that the rule does create (d) novel, legal, and policy issues. We also find the rule is inconsistent with other agencies – particularly the Federal Energy Regulatory Commission and the Internal Revenue Service.

2. *Paperwork Reduction Act* – What time and cost burdens does the regulation impose on the private and public sectors?

   The proposed regulation imposes significant time and cost burdens on companies that are much more significant than estimated by MMS. Due to time constraints imposed by a shortened comment period, we are unable to estimate with precision the extent of these burdens. We have reason to believe that they are greater than estimated by MMS. The MMS proposal creates additional burdens not described in the preamble of the proposed rule

3. *Regulatory Flexibility Act* – Outlines the analyses an agency must perform for the general notice of proposed rulemaking and for the final rule.

   The vast majority of businesses in the oil and gas industry meet the Small Business Administration's definition of small business because they have 500 or fewer employees, yet the MMS contends that only 45 companies will be affected by the proposed rule, and that only nine of these are small businesses. We believe that the impact on small producers will be much broader

4. *Small Business Regulatory Fairness Act* – Is the proposed rule's impact on the economy $100 million or greater per year; will it increase prices; and will it adversely affect competition?

   The MMS concluded that the rule will not have an impact on the economy of $100 million or more per year. MMS has not yet provided sufficient information to evaluate this finding and we are unable to comment on whether the impact is greater than or less than the $100 million threshold until MMS responds to our Freedom of Information Act request for this additional information.

5. *Executive Order 12630* – Does the proposal pose a risk of a taking of private property, and what are the financial implications of the proposal?

   The proposed rule has potential takings implications, because royalties would be assessed on value added by private-sector assets and services downstream of the lease.

In summary, based upon the above and MMS' published responses to them:

- *We find that MMS has not performed the analysis required to support the choice of its favored valuation method*
- *We find that MMS has not adequately supported its decision to dismiss competing alternatives for accomplishing its objective.*
- *We find that the proposed rule imposes undue administrative costs and uncertainty on the public sector and that MMS' own analysis has understated those costs.*

1. INTRODUCTION

The first section of the report discusses some of the feasible alternative approaches to MMS' valuation method. MMS has dismissed each of these, but has not performed the analysis required to fairly evaluate them and compare them with their favored proposal. The next sections discuss MMS' compliance with and analysis applicable to the Paperwork Reduction Act, Executive Order 12866, Regulatory Flexibility Act, Small Business Regulatory Enforcement Act, and Executive Order 12630. In making our comments on the proposed rule, our intention is to assist in the exploration of feasible alternatives and in the development of an effective and workable rule.

In general, we conclude that feasible market-driven valuation alternatives are available that (a) would more reliably yield a market value at the lease and (b) would be far less burdensome on both industry and the government. Our review of the rule indicates that MMS has a considerable amount of additional work to do before it can assert that it has fully and carefully considered the potential impacts of the proposed rule. MMS has not addressed or remedied serious problems with its proposed valuation method that Barents Group and other commenters have pointed out previously. The proposed rule contains numerous ambiguous or unclear provisions that run counter to MMS' expressed objective of "certainty" in valuation, and would impose administrative and compliance burdens on both the private sector and the government in excess of what MMS has estimated

2. ALTERNATIVE APPROACHES

MMS has not made a thorough effort to analyze and compare feasible alternative approaches of which it is already aware. Most importantly, MMS has not investigated which, if any, of its alternative valuation methods would result in a market value at the lease. This seems to be the most central question of the entire rulemaking effort, yet the MMS apparently has not attempted to rigorously address it. There may be ways to develop an index based method that is reflective of market value at the lease, but Barents has analyzed the MMS' chosen alternative and believes that it does not establish the intended goal. Indeed, as we discuss later, MMS' own analysis indicates that its proposed rule will result in something other than value at the lease.

In its *Record of Compliance*[3] submission to the OMB, MMS mentioned only one alternative to the rule in section (I)(B) *Why alternative approaches are not feasible*. MMS stated that it is in the early stages of analyzing taking royalties in kind, but asserts (without substantiation) that royalty-in-kind cannot apply for all leases. In addition, as in previous analyses, MMS comments briefly on other alternative approaches suggested in previous comment periods, but states that it "deemed the alternatives less desirable and more costly to implement than the provisions included in this further supplementary proposed rule."[4] MMS did not, however, perform a cost-benefit analysis on any of the alternatives and has not provided sufficient evidence or analysis to

[3] Record of Compliance for a Rulemaking Document, RIN 1010-AC09.
[4] Threshold Analysis, Page 8

support its rejection. The intent of E.O. 12866 is for the agency to perform a detailed analysis of more than one alternative so that it may select the most efficient alternative. MMS simply presents a few, unsubstantiated reasons for not using the alternatives. As a result, MMS has not fulfilled the requirements specified in OMB guidance MMS further potentially biases available policy options by not including any analysis of royalty-in-kind.

Comprehensive Alternative to Royalty in Value

Taking oil royalties in kind (RIK) is not a new concept for the Department of the Interior The Department has had a small refiner RIK program for decades. Two versions of this alternative have been under congressional consideration. In 1998, 17,141,584 barrels of crude oil valued at $207,828,749 were taken in kind in the small refiner program. On October 28, 1999, MMS announced that there were three successful bidders for the Pacific RIK program. The three successful bidders bid for 16,000 b/d of the 22,000 b/d offered in the sale. The sale for the one-year contract has been estimated to be worth more than $75 million.[5]

A Royalty in kind program presents an alternative that efficiently cuts right to the heart of the government's royalty valuation problem. By building up its own internal marketing expertise or by using qualified private-sector marketing agents to market its production or, the U.S. Government would achieve greater certainty than the proposed rule envisions but would do so in a way that in the long run will be less administratively burdensome, and would capture arm's-length market values through outright sales, as well as the potential for downstream value. Indeed, MMS has studied the feasibility of royalty-in kind for natural gas in the Gulf of Mexico, has initiated a crude oil royalty-in-kind pilot program in Wyoming, and is initiating a crude oil royalty-in-kind pilot program for offshore Texas as well as for the Strategic Petroleum Reserve. Despite the years of success with RIK programs, MMS states that it does not believe that taking all Federal oil in kind is in the best interests of the American public, or that such a program would enhance royalties. It makes little sense to incur the costs for government, states, and industry to completely restructure the entire crude oil valuation system when MMS is gaining experience with RIK to assess its costs and benefits.

A properly structured royalty-in-kind program would allow MMS to achieve its goals without the unnecessary administrative complexity and burden that would be imposed by MMS' further supplementary proposed rule. An RIK program would result in administrative savings in the long run to both MMS and lessees. The cost to MMS of performing audits would be dramatically reduced as they would be focused on production volumes, not on whether or not royalty was based on an arm's-length price. Similarly, for lessees, an RIK program would result in reduced audit efforts, reductions in conflicts and litigation, and reduced reporting requirements.

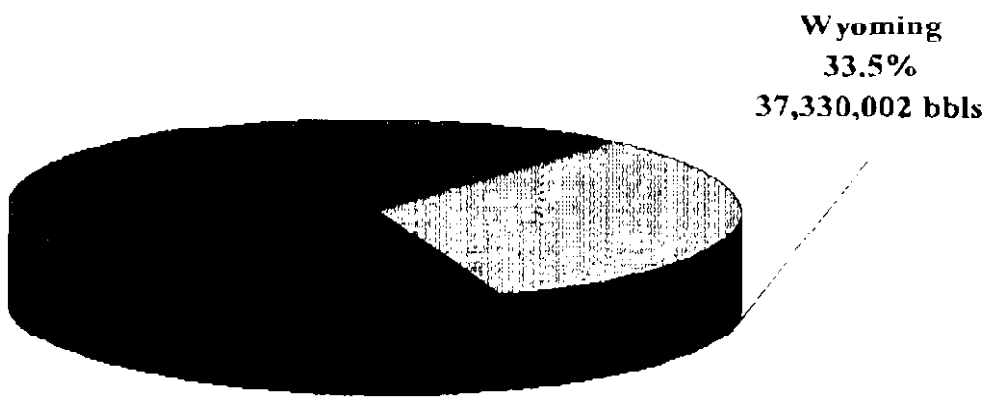
During the royalty workshops held from January 18 to January 20, 2000, at various locations in the United States, a representative of Wyoming commented that:

[5] "US sells its royalty oil," *Platt's Oilgram News*, 29 October, 1999.

Wyoming reiterates its position that states should be allowed to take their production in kind, thus resolving all valuation issues. [6]

Further, the Wyoming official stated that the state is concerned that the proposed valuation methodology "...to arrive at a netback value from Cushing, Oklahoma may have two opposite effects, neither one yielding a fair value. An independent's gross proceeds at the lease may actually be higher, based on the local supply and demand forces for quality of crude, than Rocky Mountain Region Value adjusted for transportation."[7] To date, officials in Wyoming, the state with the greatest share of Federal onshore oil production (33.5 percent), are satisfied that RIK is a workable alternative to all valuation disputes between industry and government.
Table 1 illustrates the Wyoming share of onshore Federal oil production verses the rest of the states with onshore federal oil production in 1998

Table 1: Onshore Federal Oil Production, Wyoming vs. Other Onshore States, 1998



Improved Royalty in Value – Alternatives Superior to Proposed Rule

Industry representatives have recommended the use of tendering programs for valuing oil not sold at arm's-length. MMS uses circular reasoning to dismiss tendering as a valuation option. MMS stated that it "did not adopt tendering as a general alternative in this proposal, because there are meaningful spot prices applicable in all areas other than the Rocky Mountains." In other words, MMS's argument is tantamount to saying that "spot prices exist, therefore it is not necessary to consider the tendering option." MMS has not attempted to compare the tendering and spot price methods through analysis or experimentation to determine which would lead to more accurate valuation of oil at the lease. In effect, MMS simply assumes that spot prices are a

[6] Comments at Royalty Workshops January 18, 2000 to January 20, 2000 read into record by State of Wyoming.
[7] Comments at Royalty Workshops January 18, 2000 to January 20, 2000 read into record by State of Wyoming

superior basis for assessing value – notwithstanding the fact that tendering would yield a value more proximate to the location of production, without the burden of quality, location, and transportation adjustments and notwithstanding that spot prices are reflections of value markets that are different than the lease market. The alleged superiority of MMS's spot price indexing approach does not logically follow from the fact that spot prices are readily available in many or most cases. MMS' reason for use of spot prices is convenience and certainty. However, convenience is not a proper objective and certainty has not been obtained.

In addition to this flawed reasoning, MMS states that it has substantial concerns about the potential for manipulation of tendering programs.[8] However, in explaining why tendering is an acceptable alternative in the Rocky Mountain Region, MMS states that it has designed safeguards against manipulation for tendering programs in this region. MMS does not state why similar safeguards could not also be established in other regions. MMS states that about two-thirds of crude oil production in the Rocky Mountain Region is sold at arm's-length, whereas MMS believes nationwide about two-thirds of the crude oil production is disposed of non-arm's-length.[9] At least three Federal lessees, Shell, Texaco, and Conoco currently have tendering programs. All three have filed rather extensive explanations in the rulemaking record. Texaco's and Conoco's are outlined briefly below.

Texaco's Tendering Program

After developing a tendering pilot in August 1995, and successfully testing it in the Offshore Louisiana Gulf, Texaco Exploration and Production Inc. ("TEPI") implemented tendering throughout the United States.[10] Today, TEPI tenders from approximately 12.5 percent to 20 percent of oil volumes from its marketing areas and generally an amount at least equal to its royalty share. TEPI's tendering program organizes marketing areas by oil type, and transportation method. Texaco believes its tendering program provides market value at the lease, "since the value assigned to the production reflects the price received in actual arm's-length transactions at the lease in the relevant marketing area." Tendering can enhance lease market competition and ensure that lease market value is realized. Texaco pays royalties based on values achieved under its tendering program. Indeed, tendering is the basis for valuation of TEPI's entire production in each market area, not just the royalty component. Since initiating its tendering program in 1995, Texaco has found that tendering 10 to 20 percent of production volumes is more than sufficient to establish competitive prices.

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[8] Minerals Management Service, *Further Supplementary Proposed Rule—Valuation of Federal Royalty Oil, RIN 1010-AC09, Threshold Analysis*, December 1999, page 5.
[9] 64 Fed. Reg. 73824.
[10] Texaco described the tendering program TEPI operates in comments filed with MMS on April 6, 1998 and this discussion is taken largely from those comments.

In Texaco's experience, tendering is less administratively burdensome than an index or other netback methodology that requires difficult, if not impossible, allocations, tracking, reports, and procedures.

Conoco's Tendering Program

Under Conoco's "bid-out" program, Conoco solicits bids from unrelated parties to purchase some or all of its crude oil production in various producing regions, and Conoco offers ten percent of its production volume for sale in each participating producing area. In many areas. bidders may bid for any amount between ten and 100 percent of Conoco's crude oil production, and each sale that occurs is an outright cash sale. The term of the sale is six months, and the bid price is established as a premium or deduction from a relevant posting, generally Koch's. Conoco reserves the right to reject all bids; otherwise, it sells to the highest bidder. Conoco pays Federal royalties based on the values achieved under its tendering program. In April, 1999, Conoco sold approximately 6,200 barrels of Gulf of Mexico production per day outright through its tendering program. This represents approximately 50 percent of Conoco's equity production. Conoco requested that Dr. Joseph Kalt of The Economics Resource Group, Inc. review its program to evaluate whether the program could be relied upon to yield accurate measures of the market value at the lease.[11] Dr. Kalt's conclusion was that "the bid prices revealed will generate a reliable measure of the fair market value of Conoco's crude at the lease or in the field."[12] He further stated that the design and implementation of the bid-out program clearly meet the economic criteria for achieving fair market value.

Arm's Length Lease Sales

MMS is not the first federal agency that has had to deal with valuation in the context of non-arm's length transactions. The Internal Revenue Service deals with the issue continually, and has developed some well thought out procedures for such cases. For example, Joseph P Kalt and Kenneth W. Grant have pointed out that the IRS has set out the principle that the fair market value of a transaction between two affiliates of the same parent company should be assessed by reference to comparable arm's length transactions.[13] In addition, the IRS recognizes that the use of arm's length comparables for valuation may lead to a range of market prices at a given point in time, and states that "A taxpayer will not be subject to adjustment if its results fall within such a range."[14] The IRS regulations go on to state that "a controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if the uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstances." The MMS should consider learning from the IRS's years of experience with this issue, rather than trying to 'reinvent the wheel' and impose a new and contradictory standard to that enforced by another federal agency.

[11] Appendix A of our report dated July 31, 1998 contains a copy of Dr. Kalt's response to Conoco's request.
[12] Ibid, 2.
[13] Kalt and Grant, *Declaration of Joseph P. Kalt and Kenneth W. Grant*, January 31, 2000., p. 17
[14] 26 C.F.R. 1 Sec. 1 482.1 (4-1-99 edition) at 485.

MMS asserts that State and MMS-commissioned studies found that "major producers have few truly outright sales."[15] At the July 22, 1998 Senate meeting, when asked why tendering or the other Rocky Mountain benchmarks could not be used elsewhere, MMS Director Cynthia Quarterman stated that there are few actual arm's-length sales in the Gulf of Mexico and that valid spot prices exist there. MMS states that although using supposedly comparable arm's-length sales in the field or area has been suggested by commenters as a valuation methodology, MMS states that commenters have not demonstrated the consistent existence or availability of significant volumes of these transactions.[16] For this reason, MMS dismisses this alternative as an adequate valuation method.

While MMS has not released good data on the percentage of production sold arm's-length at the lease, a very substantial share of crude oil production is currently directly sold or valued arm's length at the lease given the expanded use of tendering programs. As a rough estimate of arm's-length sales in the Gulf of Mexico (GOM), we use 1998 OGOR operated production data to estimate the share of crude oil production that may be directly valued arm's-length at the lease rather than through the use of a downstream value with adjustments. This calculation, shown in Table 2, initially assumes that producers with refineries, in general, sell production non-arm's-length.[17] This accounts for 74.7 percent of operated production. The operators with tendering programs, Conoco, Shell, and Texaco, account for 32.3 percent of total operated GOM crude oil production. Because the value received in tendering programs is used to establish value for the lessee's crude oil that is not disposed of through a tendering program, we consider all of this crude to be valued arm's-length. This share, plus the remaining 25.3 percent of production of operators without refining capacity equals 57.7 percent of total production that may be sold or valued arm's length.

The share of onshore production sold arm's length likely is substantially higher due to the greater prevalence of independent producers onshore. Even the Gulf of Mexico arm's-length estimate may be understated because lessees with refinery capacity, but without tendering programs, also sell some of their production arm's-length. On the other hand, producers without refinery capacity sell some of their production non-arm's length.

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[15] 64 Fed. Reg. 73820

[16] 64 Fed. Reg. 73824.

[17] For this analysis, we have assumed that all operators with refining capacity sell all of their operated production non-arm's-length, and that all operators without refining capacity sell all of their operated production arm's-length. This estimate is rough because (1) OGOR reports royalty oil production by operator, not by payor or lessee, (2) operators with refining capacity do sell royalty oil arm's-length, and (3) we have assumed that all operators without refining capacity will sell all of their operated oil arm's-length, without accounting for those operators with marketing affiliates.

Table 2

Gulf of Mexico Operated Crude Oil Production Potentially Sold or Valued Arm's Length, in Barrels, 1998

Operator Category	Amount	Share of Production
Total	443,843,589	100.0%
Operators with tendering programs	143,465,658	32.3%
Operators without refinery capacity	112,464,333	25.3%
Total Operators without refinery capacity and Operators tendering production	**255,929,991**	**57.7%**

Empirical analysis by Kalt and Grant shows that arm's-length sales in any given field account for a significant share of production. In addition, Kalt and Grant provide evidence that there is plenty of competition among sellers and among buyers at the field level to conclude that arm's-length prices at the lease reflect competitive market values at the lease.

Kalt and Grant state that "Publicly available data clearly indicate that there exist thousands of sellers or crude oil who participate in lease-level transactions, and the vast majority of these are not integrated into the refining segment of the industry."[18] For example, the authors cite the following:

- There were nearly 75 producers in the Gulf of Mexico in the 1990s.
- There were more than 1000 operators in Texas, New Mexico, Oklahoma, and Louisiana.
- There were more than 300 operators in the Rocky Mountain Region.

The authors state that the majority of these companies specialize in lease-level transactions and do not participate in downstream transactions or refinery operations.

Kalt and Grant also argue that an active buyers market does exist at the lease, and the fact that there exist no significant barriers to entry for buying at leases in a given field reinforces the existence of market competition at the lease. Therefore, in markets where only a few buyers are present, the potential for new market entrants ensures that prices are competitive.[19]

3. IMPORTANT CONCERNS RAISED BY OMB REMAIN UNANSWERED

Although MMS has abandoned a proposed information collection form that was rejected by OMB, a number of the concerns that OMB raised regarding that form still apply to the MMS' further supplementary proposed rulemaking dated December 30, 1999. When OMB rejected the

[18] Kalt and Grant, *Declaration of Joseph P. Kalt and Kenneth W. Grant*, January 31, 2000, p. 8
[19] Ibid.

proposed form on April 15, 1997, it stated that MMS should address the following concerns before submitting a new request for an information collection.

A. MMS must provide clear instructions to eliminate potential misunderstandings;

B. MMS must consider further reducing the universe of respondents required to submit information; and

C. MMS must further detail how this information will be used to calculate the location differentials required in this rulemaking.[20]

The concerns expressed by OMB on April 15, 1997, in its previous rejection, remain unanswered and unsatisfied by MMS. Further, while the previously proposed form is no longer required to implement the proposed rule, the issues associated with the information on the form and much of the record-keeping burden that was associated with the form remains. We discuss how each of OMB's concerns apply to and remain problematic in the current supplementary proposed rule.

A. Can the agency better define the necessary steps in order to eliminate the potential for misunderstandings?

Elimination of potential misunderstandings is an important goal of the rulemaking process. In order to properly conduct the following analyses required by the OMB, regulations must be clear and well defined: Executive Order 12866, Regulatory Flexibility, Small Business Regulatory Fairness, Executive Order 12630, Paperwork Reduction Act. The supplementary proposed rule leaves much discretion for MMS interpretation and fails to outline the exact steps companies are required to perform to comply with the rule. The proposed rule cannot be fully evaluated because it is not specific regarding key calculations in the valuation process, and contains so many discretionary elements. More importantly, failure to consider the impacts of the rule's vagueness has caused the MMS to underestimate the number of parties that would be affected by it, and the compliance time and costs that would be imposed by it. The issues of uncertainty and MMS discretion are discussed in more detail in Section 5 which discusses Executive Order 12866.

B. Can the agency reduce the universe of respondents?

A primary focus of the Regulatory Flexibility Act (5 U.S.C. Sec. 601 et seq.) is to minimize adverse impacts on small business. A regulatory basis is required that is judicially reviewable. OMB must consider efficiencies of scale that could disproportionately harm small companies and lead to further industry consolidation. Small businesses will be affected by this rule. According to the MMS, 95.5 percent of the 800 payors that pay oil royalties on federal property are small businesses as defined by the Small Business Administration (SBA).

Although the MMS claims that only 45 of 800 payors will be affected by the rule, the proposed rulemaking is likely to add additional burdens on <u>all</u> respondents. MMS has failed to recognize or evaluate the burden on all respondents. For example, by changing the current transportation

[20] Paperwork Action Summary. Office of Management and Budget, Office of Information and Regulatory Affairs. April 15, 1997.

allowance methodology, MMS is presenting pipeline owners with the additional burdens of calculating an MMS-prescribed measure of "actual transportation costs" that is inconsistent with cost measures used in the industry or imposed by other regulation; and of creating and providing paperwork to affiliates and other shippers, so that they may properly calculate their transportation allowances. MMS has also failed to properly address the fact that the proposed rule will also impact royalty payors who:

1. are independent producers, with no refining capacity;
2. are small businesses, as defined by the SBA; and
3. have a marketing affiliate

This type of producer will have to value its oil using MMS' proposed index based method when transacting with its marketing affiliates. Because the MMS has not accounted for the impacts on this kind of seller, the MMS has underestimated the economic impacts, the paperwork effects, and the small business impacts of the rule. Implications for the Regulatory Flexibility Act are discussed in more detail in Section 6.

C. *How will the information be used to calculate location/quality differentials?*

MMS' experience in designing the abandoned MMS Form 4415 helps to illustrate the complexity and specificity of market-based quality, location, and transportation differentials implicit in the market value of oil at locations remote from the lease. The question MMS must stop and ask itself is, how should a seller apply the proposed rule to properly calculate the quality and location differentials and transportation allowances when using the index-based valuation method? This major industry concern was expressed during the most recent round of MMS oil valuation workshops. The provisions regarding the required frequency and actual calculation methods outlined in the proposed rule are unclear and ambiguous. To reiterate, it is difficult to properly evaluate the consequences of a proposed rulemaking if so much uncertainty exists. This is one of the areas of greatest uncertainty with very significant economic ramifications. In Section 5 we review some of our previous comments on the proposed valuation method to which MMS has not adequately responded.

4. PAPERWORK REDUCTION ACT

The MMS is requesting comments under the Paperwork Reduction Act for the information collections associated with the further supplementary proposed rulemaking. The Act states that an agency must measure burden in terms of the time, effort, and financial resources the public must commit to comply with a request, including the time it takes for the following:

- Reviewing instructions;
- Using technology to collect, process, and disclose information;
- Adjusting existing practices to comply with the requirements;
- Searching data sources;
- Completing and reviewing the response; and

- Transmitting or disclosing information.

MMS' Paperwork Burden Estimate

MMS estimates the annual burden associated with this rule to be 17,711.5 hours and $888,575. MMS has derived these estimates based on its assumption that only 45 of 800 payors will be affected by the rule. MMS states that the affected payors are those who have refining capacity, defined as either (a) a major integrated producer with refinery capacity, (b) a large, independent producer/marketer with refinery capacity; or (c) a small, independent producer with refinery capacity. As we have previously described, many more payors will be affected by the rule than estimated by MMS in the burden estimate. Although we are not able to quantify the number of payors that will be affected by the rule, the burden estimate may be significantly higher than the annual MMS' estimated burden of 17,711.5 hours and $888,575. In addition, given that the proposed rule drastically changes the way royalty oil is valued, for MMS to assume that less than one-quarter of the payors affected by the rule will seek MMS instruction, counsel, and review is incorrect and underestimates the burden associated with the rule

Unlike previous versions of the rule, MMS does assess burden to certain activities impacted by the rule, like communication with the MMS for clarification of issues. MMS separates administration costs into the categories. In calculating the burden associated with collecting information on the differentials used in exchange agreements in order to properly value oil sold non-arm's-length, MMS classified lessees into three separate categories: those with annual production of more than 30 million barrels (13 lessees), those with annual production between 10 and 30 million barrels (4 lessees), and those with annual production of less than 10 million barrels (28 lessees).[21]

The MMS underestimates the burden associated with the proposed rulemaking for at least two reasons. First, by assuming that only payors with refining capacity will be affected by the rule, MMS implicitly neglects to include the affect on small, independent producers that have no refining capacity, but do have marketing affiliates. Secondly, by not analyzing the impact of the rule on lessees (not payors) the MMS has inadequately estimated the burden of this rule.

When estimating the burden associated with this rule, MMS has failed to consider the following issues that arise from the proposed rule:

- Payors paying on behalf of lessees will pass the cost of any incremental increase in royalty burden resulting from the proposed rule to their lessees. We do not know the exact number of federal crude oil lessees, but there are 23,000 lessees with both gas and crude oil. We would assume at least half would have either crude oil only or combined

[21] At this point, it is important to once again clarify the distinction between a federal lessee and a payor. This distinction is important when trying to understand the burden associated with this rule, as it defines the number of parties that will be affected by the rule. In performing the E.O. 12866 calculations, MMS states that 45 payors will be affected by the rule. A payor is the designated party who makes royalty payments on behalf of the lessee. However, when analyzing the burden associated with compliance, MMS refers to the number of lessees, or title interest owners, that will have a burden impact.

crude oil and gas production. As a result, many thousands of lessees are likely to be financially affected by the proposed rule.

- Companies will need to evaluate the meaning of the rule and train employees, because the rule departs from the traditional way in which equity crude oil is valued. Additional costs will be associated with setting up and maintaining a separate system to keep track of royalty oil as the equity system will still be required to handle all leases for revenue purposes.

- Additional burden associated with making special two-year election determination; requires maintenance and reelection every two years.

- Additional burden associated with choosing and maintaining the acceptable recommendations for quality, location, and transportation differentials, and indexing methodology.

- Additional burden associated with presenting unspecified materials and documentation necessary for MMS to decide whether companies are affiliates.

Although the MMS has estimated the cost associated with a number of issues for which payors might contact the MMS, the MMS has still failed to adequately address the impact of this rule on those that must change their modes of operation. This rule presents a significant burden to payors; and payors, lessees, and operators are keenly interested in the specific ways in which they will be required to operate. Perhaps burden estimating is not a precise science, but by failing to acknowledge the full scope of the rule's impact, the MMS is not operating within the framework or intent of the Paperwork Reduction Act.

Audit Costs

MMS' "Threshold Analysis" asserts that the further supplementary proposed rule would reduce audit costs to both industry and MMS, relative to the burdens under current valuation rules.[22] MMS estimates that, "the proposed rule's certainty would reduce payors' legal and other administrative costs on Federal leases by at least 5 million dollars annually ..." due to an expected reduction in valuation disputes.

However, MMS' proposal may simply replace existing audit costs and uncertainty with new kinds of audit costs and uncertainty. The proposal that lessees select their own market centers for index pricing[23] and derive their own quality adjustment has the potential to become a compliance nightmare for lessees, and audit nightmare for both MMS and lessees. MMS has not provided specific guidance on how market centers should be chosen, how quality adjustments should be estimated, or how MMS will evaluate the appropriateness of these choices and adjustments, which are likely to vary from lessee to lessee. The lack of guidance is likely to lead

[22] Minerals Management Service, *Threshold Analysis*, p. 21-22.

[23] As mentioned elsewhere in our commentary, for example, one market center may be located closest to a given lease, while a more distant market center may have crude that is closer in quality to that produced from the lease. In such as case, it is not clear *a priori* which market center should be chosen for index pricing.

to additional requests to MMS for advice on valuation. MMS' commentary on its further supplementary proposed rule does not consider the administrative costs this provision will impose on both lessees and the MMS itself, and it has not considered the uncertainty this provision will introduce into the process. MMS has not demonstrated that the cost and uncertainty will be less than under the current valuation rule.

For some large companies, the calculation of arm's-length gross proceeds will be difficult and costly. Under the proposed rule, a lessee that disposes of production both arm's length and non-arm's length must value its arm's-length production using gross proceeds and its non-arm's length production using index prices. Gross proceeds are calculated using a monthly weighted-average price. Some company accounting and business systems are not currently designed to compute weighted average prices that are linked with specific lease agreements. This is due to differences between upstream and downstream accounting systems. As a result, the large number of arm's-length sales and the multiple locations where such sales occur during a given month will result in the imposition of a very substantial burden on these companies. We spoke with one large company that previously computed weighted-average prices for natural gas dispositions and were told that this effort required 40 annual staff positions to perform. This company has estimated that a similar or greater number of positions will be required if the proposed rule is not changed. The annual cost of maintaining this staff will be approximately $2 million. In addition, this company estimates that first year computer system costs of $20 million to $25 million will be required to implement this system. We understand that other companies will face similar costs although they have been unable to provide specific figures.

5. EXECUTIVE ORDER 12866

Under Executive Order12866, agencies are required to perform a detailed cost-benefit analysis of proposed rules that either (a) are economically significant, (b) are inconsistent with other agencies, (c) deal with entitlements/grants, or (d) raises any novel, legal, policy issues. While MMS does not consider this further supplementary proposed rule to be economically significant, OMB has previously found that the proposed rule raises novel legal and policy issues. This section describes the concerns we have with the accuracy and thoroughness of MMS' analysis relevant to E.O. 12866. Barents Group has raised a number of these issues in comments on previous versions of the proposed rule, but MMS has yet to provide a substantive analysis of a number of key issues.

We were unable to obtain the data underlying MMS' Threshold Analysis, dated December 1999, thus, we cannot provide a detailed evaluation of its estimates. However, we do not believe MMS' analysis has changed substantially from the economic analysis completed for the proposed rule published in 63 Fed. Reg. 6113, and therefore, believe the key criticisms in our report dated April 7, 1998 continue to apply to the methodological and mathematical approach MMS used in analyzing the impact of the rule.[24] Because the MMS did not provide the underlying data to the public, we submitted a Freedom of Information Act Request (FOIA) to the Minerals Management Service on January 23, 2000. In the FOIA Request, we asked that the

[24] See Barents' Report, *Analysis of MMS' 'Economic Analysis of Proposed Federal Oil Valuation Rule Under Executive Order 12866,'* April 7, 1998.

MMS provide all documents, data and information including all spreadsheets and supporting workpapers used in or relative to performing the Executive Order 12866 analysis.[25] It is not possible to perform a realistic analysis of MMS' E.O. 12866 estimates before we receive the information we have requested.

Given the available information, we conclude that MMS has not investigated the costs and benefits of feasible alternatives to its rule in the level of detail that would be required to determine which valuation approach would accomplish its stated objectives most efficiently and at lowest cost. Furthermore, the proposed rule would lead to considerable uncertainty among lessees regarding how to interpret and apply the proposed valuation method, and would create uncertainty by leaving MMS with considerable discretion over how to interpret and apply it in specific cases. Below, we support these conclusions by discussing elements of MMS' proposed valuation method that raise concerns and require further analysis.

Barents Comments of April 7, 1998 Not Addressed by MMS

Throughout the federal oil valuation rulemaking process, Barents Group[26] and others have commented on a variety of issues dealing with the burden the proposed rulemaking imposes on affected parties. Since the beginning, we have had serious doubts regarding MMS' methodological assumptions, which have led us to suggest and evaluate a series of alternatives. We have analyzed a number of fundamental issues that lead us to believe that the MMS' proposed rule is fundamentally flawed. The following points highlight the issues we raised in our previously filed comments that have not yet been substantively addressed by the MMS.

1. The MMS valuation method does not yield fair market value for crude oil at the lease.

Original Barents comments. MMS has not attempted to determine whether its proposed valuation method results in fair and reasonable estimates of crude oil value at the lease. The proposition that MMS' valuation method will yield fair market values for crude at the lease remains an untested assertion.

MMS' response. MMS has asserted that, "... generally there is no price transparency at the lease or field level. None of the comments submitted throughout this nearly four-year rulemaking effort demonstrated that as a general rule a competitive market exists at the lease."[27] MMS has not published any estimates that attempt to compare those prices at the lease that are observable to the prices that would result from its proposed valuation method

MMS' response does not address the comment. There are theoretical and practical reasons to question MMS's further supplementary proposed rule. Even though the proposed rule's changes

[25] The FOIA also requested all estimates of the burden associated with the Regulatory Flexibility Act, the Small Business Regulatory Enforcement Fairness Act, the Unfunded Mandates Reform Act, Takings, Federalism, Civil Justice Reform; and the Paperwork Reduction Act.

[26] "Analysis Of The Department Of Interior, Minerals Management Service Proposed Rule Establishing Oil Value For Royalty Due On Federal Leases And On Sales Of Federal Royalty Oil," Barents Group LLC, May 28, 1997.

[27] 64 Fed. Reg. 73820

represent a major departure from the current rules. MMS has not adequately tested its valuation methodology to determine whether it yields accurate market values at the lease, and we believe it does not represent value at the lease. It is not known how well its method's calculated values match up with prices in actual arm's-length transactions. MMS's evaluation of five (MMS-selected) alternative valuation approaches is inadequate and does not reflect a careful analysis of the relative merits and likely accuracy of each proposal.

2. *FERC tariffs provide a ready, reliable method for calculating transportation costs.*

Original Barents comments. Disallowing the use of FERC tariffs is burdensome, expensive, and inequitable. The proposed rule requires that companies make transportation adjustments based on "actual costs" and eliminates the lessee's ability to use FERC and State-approved tariffs when computing royalties. This requirement will result in substantial compliance and administrative costs and inequities. Additionally, substantial costs will be incurred by many pipeline companies, and competing shippers will be treated inconsistently.

If a contract involves production from more than one lease, there could be different transportation arrangements from each lease, adding to the effort required to construct actual costs.

The establishment of cost-based tariffs is a highly labor-intensive process and often requires incurring outside consulting and legal fees that FERC was largely able to eliminate through regulatory action taken in 1993. MMS would effectively eliminate all cost savings that FERC achieved in this area.

In its comments filed with MMS on May 27, 1997, Chevron Pipeline Company (CPL), a common carrier, discusses the burden that the disallowance of FERC tariffs will impose on it, and also on MMS. The proposed rule details what may be included in "actual costs", and the "regulations do not track the manner in which CPL is required to maintain records under the Uniform System of Accounts for Oil Pipelines established by the FERC....Nor do the MMS regulations calculate a pipeline's costs in the same manner as the FERC does in determining if a pipeline's rates are just and reasonable under the ICA [Interstate Commerce Act]."[28] Complying with the proposed regulations would require that CPL generate new and different financial analyses and records than it keeps in the ordinary course of business.

Not only will the requirement to use "actual" transportation costs place a huge burden on pipeline companies and their affiliates, but it also creates inequities because the rule only requires companies affiliated with a transportation company to use "actual costs". If a shipper is unaffiliated with a pipeline, it may continue to pay FERC tariffs to the unaffiliated pipeline. This results in shippers with an equity interest in a pipeline being required to use "actual cost" calculated according to MMS rules, while competitors could deduct higher actual tariffs for shipments through the same pipeline. This can also place companies with an equity interest in, or affiliated with, a pipeline at a competitive disadvantage.

[28] Chevron Pipeline Company comments to Minerals Management Service, page 8. May 27, 1997.

MMS' response. "This supplementary proposed rule continues MMS's position that FERC tariffs should not be permitted as a substitute for actual costs in non-arm's-length situations. We continue to believe that FERC tariffs often exceed the transporter's actual costs. ... MMS continues to maintain that it is fair to allow a lessee with an arm's-length transportation contract to use the amount it pays to the pipeline while limiting a producer transporting over its own pipeline to its actual costs. In both cases the amount allowed represents the actual costs incurred to transport the oil. MMS also maintains that where producing and transporting affiliates are involved, the entity claiming the allowance should be able to acquire any needed records from its affiliate. It may be true that audit costs could be somewhat higher without the FERC tariff option. However, we believe that the principle of permitting only actual costs, including a reasonable rate of return, is consistent with longstanding royalty valuation and allowance principles and fairly and reasonably protects the public interest."[29]

MMS' response does not address the comment. MMS continues to miss two key points: that the relevant *actual* cost of transportation should include the pipeline owner's opportunity cost – not simply its outlays or expenditures incurred in operating the pipeline – and that the rule will impact the competitive positions of market participants. MMS is effectively denying to pipeline owners recovery of their full opportunity cost of transporting their own oil through their own pipelines, while effectively allowing a similar cost (embedded in the FERC tariff) for lessees who do not own pipelines. This creates a tilted playing field. MMS has not addressed the impacts on competition, or on the structure of the market, that would result from allowing different transportation deductions to different lessees depending on whether they are pipeline owners.

3. *MMS has substituted spot prices for futures prices as the starting point for valuation, but relies on the same erroneous reasoning.*

Original Barents comments. A key conceptual problem with MMS' previous choice of the NYMEX futures price as the starting point for royalty valuations was that "MMS had it exactly backwards in concluding that oil markets are "driven" by the futures market, because the futures price is necessarily derivative from market prices."

MMS' response. In its further supplementary proposed rule, MMS now states that, "In the United States, with the exception of the Rocky Mountain Region, spot and related index-type prices *drive the manner in which crude oil is bought and traded*." [emphasis added] MMS goes on to state that, "We believe spot prices are the best indicator of value for production from leases outside the Rocky Mountain Region. Therefore, it is not necessary to consider other, less accurate means of valuing production not sold at arm's length for regions outside the Rocky Mountains." MMS attempts to support these assertions with the further assertion that, "Spot prices play a significant role in crude oil marketing. They form a basis on which deals are negotiated and priced and are readily available to lessees via price reporting services." (64 Fed. Reg. 73832)

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[29] 64 Fed. Reg. 73834-73835.

MMS' response does not address the comment. The fact that spot prices may play a significant role in the market, and that *average* or *assessed* spot prices may be readily observed is not sufficient to demonstrate that spot prices can be used as a basis for accurately valuing oil at the lease. Support for these assertions can *only* be provided by a careful empirical analysis, which MMS apparently has not done. For example, MMS has not demonstrated that each of the spot markets to be referenced for index pricing has sufficient volume, depth, and frequency of trading to provide consistently reliable indicators of market value. Indeed, unlike in its original proposed rule, MMS has not even included a list of proposed market centers in its current proposal. At no point in the regulatory process has MMS supported the claims that spot prices "drive" the market and that they are a reliable indicator of value for the purpose MMS proposes – let alone the *best* indicator of value. We wonder how MMS can assert that one or another index is "best" when it apparently has not done the requisite analysis.

MMS stated that comments by workshop participants helped to convince MMS that an index-based methodology using spot prices would be an improvement over using NYMEX. We might agree with that narrow point: using spot prices is a slight improvement over using *both* spot prices and NYMEX (MMS's original proposal), but only in the sense that it eliminates one of the flawed steps in MMS's original proposal that would have removed valuation of oil even farther from the lease. However, it does not follow from this point that the use of spot prices is the *best* method among the feasible alternative methods. Removing one flawed step from a multi-flawed approach does not necessarily improve the approach.

Not only are spot prices a dubious value index, but there is empirical evidence to support the notion that posted prices are widely used as the basis for outright arm's-length sales at the lease – contrary to MMS' continued assertions that posted prices do not reflect market values. The MMS has rejected the use of posted prices based on unsupported assertions that posted prices are not meaningfully employed in actual transactions and/or are tainted by a lack of competition in lease-level commerce. However, Kalt and Grant have found that,

> *"As a general rule, based on repeated results for oil field after oil field in the U.S., posted prices lie within the range of prices struck in arm's-length comparable transactions ... Specifically, posted prices (and transactions at posted price) commonly lie within the range of prices that defines market value, as observed in outright purchases and sales of crude oil in the field. Moreover, this conclusion is not confined to onshore producing areas. The same pattern is revealed offshore.*[30]
>
> *Overall, for those observations within our data that provide the underlying pricing basis, approximately one-third of such transactions are at a posted price. For the Cowden and Amos Draw fields, approximately three-quarters of all such transactions ... are at a posted price. In the offshore case of Eugene Island ... virtually all of the arm's-length transactions are at a posted price.*

[30] Declaration of Joseph P. Kalt and Kenneth W. Grant, Harvard University and Lexecon Inc., January 31, 2000. Comments filed with the Minerals Management Service.

In other words, the empirical evidence indicates that posted prices are *not* merely arbitrary placeholders used in intracompany transfers and intercompany exchanges (as MMS has argued), but actually reflect fair market value based on competitive forces.

4. *MMS has not provided any evidence or analysis to support its position that spot prices are a reliable basis for determining value at the lease.*

- **Original Barents comments.** One of the inherent problems with using spot prices as valuation indices is that they reflect only one segment of the market, and ignore the values set in term contracts and exchange agreements. Spot prices represent the cost of obtaining crude for delivery within 30 days. By contrast, a great deal of market activity is accounted for by longer-term contracting arrangements – chiefly refineries contracting for a stable supply of crude over a period of many months. Refiners commonly turn to spot markets to balance out short-term supply/demand imbalances, but rely on longer-term contracts to meet most of their needs. Depending on supply and demand conditions at any given point in time, spot market prices could represent either a premium or discount relative to term contract prices. These facts lead to the conclusion that price discovery in spot markets is bound to be somewhat limited. The large volume of oil that changes hands outside of spot markets should raise doubts about the ability of average spot prices to function as indicators of market value at the lease.

- **Original Barents comments.** Published spot price "assessments" are based on a limited polling of traders in each market plus the judgments of the publications' reporters. They do not reflect an average of spot transactions or even the price in any particular transaction. In some cases, they represent bids and offers to buy or sell crude oil, but not necessarily final, market-clearing sales prices. Problems with spot market assessments published by reporting services were cited as the reason the Department of Energy ended its long-standing practice of pricing crude from the Elk Hills Naval Petroleum Reserve (NPR) based on the average of spot prices published by Reuters News Service and Telerate for ANS and Line 63 crude.

- **Original Barents comments.** On some days, there may be no spot trading, so the quoted price may simply be the same price as reported on the previous day or may reflect a judgment call by the publication's analysts based on information from other markets or recent price differentials with more active markets. In thinly traded markets, the assessed price may reflect information from the trades of just a few market participants and, therefore, may reflect the unique circumstances of these participants and may not be reliable indicators of the underlying market conditions.

MMS' response. MMS has not directly replied to any of these criticisms. The further supplementary proposed rule provides no evidence that MMS has investigated these problems or analyzed how these problems would impact the valuations resulting from their proposed spot-price-based valuation method.

5. *Multiple differentials exist when attempting to value crude oil starting with an index price– not just quality, location, and transportation.*

Original Barents comments. The transportation cost deduction permitted under the proposed valuation method results in an upward bias in the oil value assessed for royalty purposes. The proposed rule includes the value of certain downstream services in its calculations of royalty value, resulting in an upward bias in royalty value. The price differential between the lease and the ultimate disposal point for a given grade and quality of oil is not the same as the cost of transporting that oil from the lease to the off-lease disposal point -- the differential is generally greater than the costs of transportation. Therefore, starting from some market center spot price and backing off the cost of transportation as a means of calculating a value at the lease will bias the calculated value of the crude upward to the extent that additional services (such as aggregation and marketing) add value to the crude between these two locations.

MMS' response. MMS has made revisions to its prescribed method for calculating transportation costs (such as improving the pipeline depreciation allowance), but MMS still contends that transportation cost, location, and quality adjustments are the only adjustments needed to translate a downstream market price into a market value at the lease. MMS has also requested comments on the appropriate rate of return to allow in its prescribed "actual cost" calculations.

MMS' response does not address the comment. Although MMS has proposed a change in its transportation allowance calculation, the change does not address the central criticism that downstream value encompasses more than transportation costs, location, and quality differentials. While MMS' proposed changes would moderate the economic impact of the proposed rule, it does not address the compliance costs and does not allow a deduction that would guarantee producers a good measure of lease value.

Problems with the New Proposal

MMS states that the use of its proposed index-based pricing would bring certainty to the valuation process, yet sufficiently many details are left unexplained in the proposed rule that certainty is unlikely to be achieved. In the case of several key sections of the proposed rule, no guidance is provided to lessees on how adjustments or allowances should be calculated or estimated, or on how MMS will judge the reasonableness of lessees' calculations and estimates. Important aspects of how one makes transportation, location, and quality adjustments are missing from the proposed rule. In a number of situations, lessees will need to apply to MMS for guidance. MMS will continue to retain considerable discretion over how to apply its proposed rule. The Appendix to this report lists and discusses 13 specific instances where uncertainty or ambiguity remains, and where MMS will be allowed to exercise discretion rather than follow rules or methods established in advance.

For example, consider the California independent producer that is brought under the index pricing method. The lessee must start with the average of the daily mean ANS spot price for the calendar month preceding the production month. This average daily mean is not published, and so the lessee must first obtain the data and then calculate the average daily mean for the appropriate month. The ANS spot price must then be adjusted for location and quality differentials. The allowable differentials vary depending on the disposal point and require the lessee to select from a complex "menu of options."

The lessee must select the appropriate adjustments and be able to demonstrate to MMS which adjustments were used. The methodology is similar for the rest of the country, excluding the Rocky Mountain area, but rather than using the ANS spot price, the lessee must begin with the published spot price for the market center closest to the lease and of smaller equity.

The complexity of the proposed oil valuation rule is illustrated in the flowchart attached at the end of this report. Further detailed examples of the lack of clarity and the scope for MMS discretion are provided in the appendix.

6. REGULATORY FLEXIBILITY ACT AND SMALL BUSINESS REGULATORY ENFORCEMENT ACT

The Regulatory Flexibility Act of 1980 outlines the analyses an agency must perform for the general notice of proposed rulemaking and for the final rule. The Small Business Regulatory Enforcement Act outlines the additional requirement that regulations having an annual effect on the economy of $100 million or more be evaluated by the Comptroller General. In its Threshold Analysis, MMS contends that the further supplementary rule will not have a significant economic effect on a substantial number of small entities.

MMS contends that only 45 companies will be affected by the proposed rule, and that only nine of these are small businesses.[31] We believe that the impact on small producers will be much broader. These costs have neither been recognized nor seriously considered by the Department. Indeed, notwithstanding numerous attempts to call the burden to the Department's attention, it continues to insist that there is no significant small business impact.[32]

The vast majority of businesses in the oil and gas industry meet the Small Business Administration's definition of small business because they have 500 or fewer employees. Refineries with 1500 or fewer employees meet the Small Business Administration's definition of small business. Indeed, MMS states that 764 (95.5 percent) of the 800 businesses that pay royalties to MMS on oil produced from federal leases are small businesses as defined by the Small Business Administration. No data are yet available to accurately quantify these effects. This brief discussion qualitatively describes these effects on small business.

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[31] See 63 F.R. 6113 published February 6, 1998, subsequent modification 63 F.R. 38355 published July 16, 1998, and subsequent modification 64 F.R. 73824, published July 16, 1998.

[32] See, for example, the October 2, 1998 letter to the editor of The Oil Daily from Ms. Cynthia Quarterman, Director, Minerals Management Service, where she says "I continue to be baffled by independent oil companies being told, and believing, that the proposed oil valuation regulations will increase their royalty obligations. This is simply not true."

- Independent producers who sell arm's length have specific concerns with the burden imposed by MMS' "newly minted" duty to market. They are concerned that MMS may choose to look through gross proceeds in an attempt to find whether marketing costs have been deducted. This could subject even those who sell outright at the lease to additional uncertainty and costs. The proposed rule does not address this issue and the impact on small producers could be substantial.

- Independent producers with marketing affiliates would be directly affected by the proposed rule. MMS has also failed to properly address the fact that the proposed rule will also impact royalty payors who: (a) are independent producers, with no refining capacity; (b) are small businesses, as defined by the SBA; and (c) have a marketing affiliate. This type of producer will have to value its oil using MMS' proposed index-based method when transacting with its marketing affiliates. Because the MMS has not accounted for the impacts on this kind of seller, the MMS has underestimated the economic impacts, the paperwork effects, and the small business impacts of the rule

- MMS continues to insist that only 45 payors will be affected by the proposal, and that only nine (or ten) of those are small businesses as defined by the U.S. Small Business Administration. We assume that the MMS is using the definition of 1500 or fewer employees, but MMS did not clarify this in their report. By limiting the analysis to refiners, MMS simply assumes that independent producers are unaffected. This is not the case

- If the lessee is required to value crude oil using one of the proposed non-arm's-length methods, it will likely end up overpaying royalties. These overpayments will result from the requirement that in most cases royalty values are to be based on downstream market values rather than lease market values. MMS' allowed adjustments will not correct this mismatch between markets.

- Finally, the further supplementary proposed rule specifies a number of ambiguous recordkeeping requirements necessary to show how the lessee or its affiliate calculated value for royalty purposes. Complying with each of these requirements will require substantial recordkeeping time, and MMS must consider the impact of the further supplementary proposed rule on this estimate of burden

7. TAKINGS: EXECUTIVE ORDER 12630

MMS' "Record of Compliance for Rulemaking" submitted to OMB states that, "In accordance with Executive Order 12630, this further supplementary proposed rule does not have significant takings implications." In addressing the requirements of Executive Order 12630 in the proposed rule itself, MMS was replying to a comment received on its February 1998 proposal in which the commenter argued that "the proposed rule deprives lessees of their constitutionally protected property rights when royalties are paid based on a higher than actual lease sales price." The commenter argued that because a taking would occur if the proposed rule were adopted, MMS is required to prepare a Takings Implication Assessment pursuant to Executive Order 12630. MMS replied that, "Disagreements over methods of valuing production for royalty purposes do not change the property relationship between the lessee and the Federal lessor, and do not operate to deprive the lessee of any property interest."[33]

It appears from MMS' reply that it misunderstood the fundamental nature of the property right regarding which the commenter was asserting a takings issue. The takings issue is not simply a question of disagreement over how to value production at the lease for royalty purposes. Rather, the relevant issue requiring analysis appears to be whether the proposed rule would have the effect of denying to certain lessees or their affiliates the rights to the economic returns of their investments and efforts in downstream marketing and distribution capabilities.

To see this distinction, it helps to lay out specifically some of the distinct elements of the value of crude oil delivered at some location removed from the lease (such as at a market center, aggregation point, or refinery). In broad terms, as discussed earlier, the value of a given quantity of crude oil at some point of disposition equals the value of that oil *at the lease* plus value added to that oil after it leaves the lease. The value added to the oil after it leaves the lease includes (but is not limited to) value added by transportation to a different location, by downstream marketing activities,[34] by aggregation of volumes, by storage, by risk-bearing services, and by other activities. Because supply and demand factors may differ from location to location, part of the value added by marketing activities consists of identifying where production can be sold for the highest price, and moving it to that location. Downstream service providers earn a profit for providing services and accepting risks. The market value of the services they provide – their costs of doing business plus a return on their invested capital (physical and human) – is one of the elements of the value added to production downstream of the lease. Given these facts, it follows that simply subtracting "actual transportation costs" from a downstream market value does not lead to a measure of value at the lease.

This value is added downstream whether the services and risk bearing are provided by a lessee (or affiliate) or by an independent marketer (who may purchase the production at the lease in an arms-length transaction). Nevertheless, the proposed rule would treat these two kinds of scenarios differently. This is where a potential takings issue arises. To see this, compare two arms-length sales by a lessee: one at the lease and one away from the lease. If a lessee sells its oil at arm's length at the lease, it would pay royalties under the proposed rule based on its "gross proceeds" received at the lease. If the same producer performs its own transportation and marketing and disposes of this same oil away from the lease, it would pay royalties under the proposed rule based on its "gross proceeds" received at the point of sale, less a deduction for the lessee's actual cost of transportation (as defined under the proposed rule).

As can be seen from the discussion of value added by downstream transportation and marketing activities, the value assigned in the second case will be greater than the value assigned to the

[33] 64 Fed. Reg. 73838-39

[34] Marketers provide valuable services that involve not just moving oil from one location to another but also aggregating oil, finding buyers, maintaining long term relationships with buyers, contracting, tracking markets, and timing sales. Marketing activities also entail the bearing of risks of price fluctuations, loss due to spills or transportation failure, credit risk of purchasers and *force majeure*.

same production in the first case. This is because only transportation costs, and not the value added by downstream activities, have been deducted from gross proceeds. It follows from this exposition that, in the second case, the Federal government would receive a royalty that in part represents some of the costs incurred and profits generated by the lessee in its downstream activities. This result is in direct contradiction to MMS' consistent statements that the intention of its rulemaking is for the Federal government to receive its royalty share of the market value *at the lease*.[35]

> *Because the proposed valuation method would result in MMS' collecting a share of the returns to private downstream investments (which constitute private property) in transportation and marketing services, the proposed rule appears to have takings implications.*

According to the U.S. Attorney General's "Guidelines for the Evaluation of Risk and Avoidance of Unanticipated Takings," "a 'significant takings implication' exists when, on the basis of available information, the decisionmaker concludes as to any policy or action with a takings implication that: the proposed policy or action poses a substantial risk that a taking of private property may result, or insufficient information as to facts or law exists to enable an accurate assessment of whether significant takings consequences may result from the proposed policy or action."[36] When a policy or action has significant takings implications, "An agency must evaluate its administrative and regulatory policies and actions that affect, or may affect, the use or value of private property." On this basis, the Attorney General's Guidelines appear to require that MMS perform a Takings Implications Assessment.

8. CONCLUSIONS

MMS has stated time and again that the primary objective of its proposed rulemaking is to establish a market value of crude oil at the lease. Feasible market-driven valuation alternatives are available that (a) would more reliably yield a market value at the lease and (b) would be far less burdensome on both industry and the government. In making our comments on the proposed rule, our intention has been to assist in the exploration of these alternatives and in the development of an effective and workable rule.

In general, we find that

- *MMS has not performed the analysis required to support the choice of its favored valuation method.*

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[35] See, e.g., MMS *News Release*, February 5, 1998: "royalty payments [should be] based on no more than the *value of production at the lease*." [emphasis added] And, 62 Fed. Reg 3747, January 24, 1997. "The purpose of these adjustments and allowances is to reflect value differences for crude oil production of different qualities and at different locations to derive a *value at the lease*." [emphasis added]

[36] Section IV of the Guidelines.

- *MMS has not adequately supported its decision to dismiss competing alternatives for accomplishing its objective.*

- *The proposed rule imposes undue administrative costs and uncertainty on the public sector and that MMS' own analysis has understated those costs*

Voluminous comments have been provided to MMS explaining the deficiencies and burdens inherent in its previous valuation proposals. We find that many of these same deficiencies and burdens are inherent in its latest proposal. MMS still has not acknowledged these fundamental problems. In response to the many comments, MMS has made only small changes in the valuation model it originally proposed three years ago. None of the changes remedy the basic flaws that we and others have pointed out from the start.

In its most recent proposal, MMS did not give sufficient consideration to alternative approaches that are far simpler, more market orientated, and more apt to yield a market value at the lease. We suggest that MMS study carefully the tendering and royalty-in kind programs that are currently in place. We also suggest that MMS study carefully the likely outcomes under its proposed indexing formula so that it can fairly make comparisons with alternative policies.